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Proposal for amendments to article 5 of the United Nations Model Double Taxation Convention between Developed and Developing Countries*,**

Summary

The present paper examines article 5 of the United Nations Model Double Taxation Convention between Developed and Developing Countries together with the Commentary thereon. Three questions in particular are addressed:

(a) Should article 5 be amended and if so, in what manner?

(b) Should the Commentary on article 5 be amended and if so, should the amendments be similar to the recent amendments to the Commentary on the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (OECD)?

(c) How can the OECD position be improved?

The proposed amendments are summarized in the conclusion.

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Introduction

1. The current United Nations Model Double Taxation Convention between Developed and Developing Countries (and its Commentary) (United Nations, 2001) had last been amended in 2001. The 2000 amendments to the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (OECD) were as it seems, taken into account in that 2001 amendment. The counterpart of the United Nations Model Tax Convention, the OECD Model Tax Convention (and its Commentary) was further amended in 2003 and 2005. The need was felt to analyse the current United Nations Model Tax Convention and propose any amendments deemed opportune. In that context, article 5 of the United Nations Model Tax Convention and article 5 of the OECD Model Tax Convention were examined and a comparison was drawn up. The amendments to the OECD Model Tax Convention and the Commentary thereon were further evaluated as to whether such amendments should also be reflected, or further improved, in the United Nations Model Tax Convention and Commentary.

2. The question whether article 14 of the United Nations Model Tax Convention is to be deleted (as was the case for article 14 in the OECD Model Tax Convention) is outside the scope of the authors' task, which is to recommend changes to article 5.

3. In general, it is useful to monitor changes to the OECD Commentary and possibly amend the United Nations Commentary accordingly since (a) clarification is always beneficial; (b) negotiation with developed States is facilitated when the starting point between the negotiating parties is similar; and (c) it would be beneficial to make use of OECD resources by basing possible amendments on OECD amendments to the OECD Model Tax Convention and Commentary, inasmuch as those amendments were well thought out and well researched.

4. The present proposal will address three questions in particular: (a) should article 5 be amended and if so, in what manner? (b) should the Commentary on article 5 be amended and if so, should the amendments be similar to the recent amendments to the Commentary on the OECD Model Tax Convention? and (c) how can the OECD position be improved?

5. In formulating this proposal, the elements of practicality and effectiveness were guiding. Not only must the amendments to the United Nations Model Tax Convention and/or Commentary thereon be beneficial to all States Members of the United Nations, including the developing countries, but such amendments should also facilitate the negotiating parties' coming to an agreement.

6. In general, most of the OECD changes to the Commentary have resulted in the widening of the permanent establishment concept (Pijl, 2002), for example, the conclusion that no human presence is required to constitute a permanent establishment. Some of the amendments to the OECD Model Tax Convention, however, include a narrowing of the requirements for constituting a permanent establishment. This goes against the perceived objective of the United Nations Model Tax Convention which gives more weight to the source principle, resulting in a wider definition of permanent establishments.

7. In the authors' view, the permanent establishment concept is narrowed in cases where, in e-commerce transactions, the server in the source country is not at the disposal of the enterprise when a service contract with an Internet Service Provider

is concluded. According to the OECD Commentary, no permanent establishment exists in such a case. In the opinion of the authors, this position should be accepted but the Commentary should include the possibility that, in this case, substance overrides form.

8. The authors suggest that the United Nations follow the OECD Commentary except in respect of the issues mentioned below.

9. Should the United Nations not be willing to follow this approach, the option could be considered of not including certain amendments added pursuant to the recent interpretations of OECD and leaving it up to the domestic courts to decide on the interpretation to be given.

10. The OECD examples found in the Commentary are sometimes rather dated and more up-to-date examples could be given. On the other hand, the greater the similarity between the OECD and United Nations Model Tax Conventions, the smaller the risk of the negotiation talks being hindered between parties following the OECD Model Tax Convention and those following the United Nations Model Tax Convention. The authors thus advise that the examples be left as they are.

I. Permanent establishments or other source principles

11. The source principle binds the primary right to taxation to the territory of the country from which the income emanates/derives. According to OECD tax policy, recognition of a wider source principle in the case of developing countries, is regarded as espousing "economic aid" for less developed capital-importing countries rather than a form of equitable distribution of the income tax base (Messere and Owens, 1988).

12. Besides the classic source principle — namely, that of the permanent establishment — other source principles have recently been proposed. Kemmeren (2001), for example, proposes a new jurisdictional connection: the principle of origin. According to this author, there should be four qualitative principles: (a) the principle of origin, (b) the principle of source, (c) the principle of residence and (d) the principle of nationality. Kemmeren makes a distinction between origin and source. He is of the opinion that the essence of the allocation of tax jurisdiction does not lie in the "physical" place where income is formally generated, but rather in the place of origin of income, that is to say, the place where the intellectual element is to be found or a substantial income-producing activity is carried on, and where the wealth is created. This proposal is very innovative and was discussed extensively in the last International Fiscal Association Congress, held in Buenos Aires (*Cahiers de droit fiscal international*, 2005).

13. We are of the opinion, however, that, owing to the difficulty of implementing such innovative ideas in practice, consideration of these proposals should be waived at this point in time.

14. Attention must be paid to the effect of the actual wording of the Commentary: if the wording is drastic, local courts might ignore the changes. In a recent example,[1] the Norwegian Supreme Court ruled (8 June 2004) that the provisions of paragraph 6 of the OECD Commentary as changed in 2003 were to be rejected.

[1] *PGS Geophysical AS* v. *Sentralskattekontoret*.

Under paragraph 6 of the OECD Commentary, activities existing for a very short period of time could lead to a permanent establishment when the nature of the business so justified. Although this can be considered a sympathetic attempt to widen the scope of the permanent establishment concept, it is also to be considered that such rejected positions have a negative bearing on the status of the whole Commentary as a source of interpretation.

15. In the authors' view, such far-reaching statements are better avoided, unless they have a solid basis in customary case law.[2]

II. Amendments to the text of the United Nations Model Tax Convention

16. The authors of this proposal are of the opinion that the text of article 5 of the United Nations Model Tax Convention should not be amended or altered in any way.

III. Amendments to the Commentary

17. As noted above, the OECD Commentary was amended in 2003 and 2005, whereas the United Nations Commentary had been last amended in the year 2001. This proposal will tackle the OECD Commentary and comment on whether the amendment of the United Nations Commentary should be similar to, or different from, that of the OECD Commentary. As a general rule, the authors advise that the United Nations Commentary should be based on the OECD Commentary, with the exception of the issues indicated below.

18. The position expressed in paragraphs 4.5 and 4.6 of the OECD Commentary (a painter who repaints a building has the building at his disposal, and a road-paving enterprise has at its disposal the location where the road is being paved) is accepted by OECD, except for Germany, which made an observation in 2005 and does not accept a place of business at the disposal of the enterprise in this case.

19. In the authors' opinion, however, a painter who repaints a building indeed has the building at his disposal, and a road-paving enterprise has at its disposal the location where the road is being paved. Article 5 (1) includes not only the place of business that provides the facilities (the entrepreneur works *in* his office) but also the place of business that may be the object of the enterprise's activities (the painter works *on* the building).

20. Furthermore, the example of the road-paving enterprise clarifies the relationship between article 5 (1) and article 5 (3), namely, that 5 (3) is a special rule under the general rule of article 5 (1) (Pijl, 2005).

21. The United Nations could consider making this further explicit.

22. While paragraph 6 of the OECD Commentary widens the scope of permanent establishment, care must be taken not to include measures so drastic that they could easily result in the amendments being rejected by the domestic courts. As a result of this, the authors conclude that paragraph 6 should not be added to the United

[2] In a forthcoming publication in *European Taxation*, the first author discusses the negative effect that a deviating Court view has on the status of the Commentary.

Nations Commentary. It should be left to the courts to interpret the permanence criterion at this stage. Though further clarifications may contribute to the development of an internationally coherent system, at this stage it is not wise to attempt to do this in the context of the temporal scope of permanence.

23. The authors draw attention to paragraph 19, eighth sentence, of the OECD Commentary which reads: "If an enterprise (general contractor) which has undertaken the performance of a comprehensive projects subcontracts *parts* of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project" (emphasis added). This exact wording is reflected in the United Nations Commentary, paragraph 11, second indention. The term "parts" of such project indicates that if an enterprise had to subcontract *all* the project, this would not amount to a permanent establishment of that enterprise in the State of subcontraction.

24. This narrows the definition of "permanent establishment" and our proposal is that the wording "all or parts of the projects" should be used.

25. Paragraph 17 of the OECD Commentary, was amended in 2003. The amendments widen the definition of "building site or construction or installation project" rather extensively. Post-2003, renovations and installations, planning and supervisions may amount to a permanent establishment. The third sentence of this paragraph specifically reads: "On-site planning and supervision of the erection of a building are covered by paragraph 3." This wording entails that the amendments, while extending the definition of permanent establishment, limit "planning and supervision" to the erection of buildings and do not also encompass the complete wording of article 5 (3) of the OECD Model Tax Convention, which encompasses planning and supervision of *constructions or installation projects*. This is probably to be considered an oversight. The authors' proposal is that the third sentence read: "On-site planning and supervision of the erection of a building, construction, assembly or installation project are covered by paragraph 3." (The authors are aware that article 5 (3) (a) of the United Nations Model Tax Convention contains a reference to "supervisory activities". They note, however, that planning is not included.)

26. Paragraph 33, fourth sentence, of the OECD Commentary refers to the negotiation of "*all* elements and details". The question arises whether, if the essential elements (but not all elements) are negotiated by the agent, this would still amount to an agency permanent establishment. In other words, if some minor detail is decided by the general enterprise, and not by the agent, would this not give rise to an agency permanent establishment? If this is the interpretation given, it could easily lead to abuse. Two non-member countries have taken a contrary position to that of the OECD Commentary in this respect (para. 21: positions on the Commentary to article 5 of the OECD Model Tax Convention).

27. To avoid difficulties in interpretation, the wording "authorised to negotiate all elements and details of a contract in a way binding on the enterprise" (para. 33 of the OECD Commentary) should be amended to read "authorised to negotiate all major elements and details of a contract in a way binding on the enterprise".

28. It is important that the new United Nations amendments include the substantial elements included in the 2003 additions to the OECD amendments on electronic commerce (paras. 42.1-42.10).

29. Of critical importance is paragraph 42.6 of the OECD Commentary, which widens the definition of "permanent establishment" by specifying that no physical presence is required to establish a permanent establishment. This amendment is in line with the aims of the United Nations Model Tax Convention and Commentary and it would be beneficial to include it in forthcoming amendments to the United Nations Commentary.

30. However, the provisions of this paragraph, despite the title of the sub-chapter (Electronic commerce), also apply to cases other than e-commerce, as follows from its wordings. The authors suggest expressing this in the title of the sub-chapter, which could read: "Electronic commerce and other activities with automatic equipment".

31. There is also a conflict between the content of current paragraph 10 and that of current paragraph 42.6 of the OECD Commentary. In the light of the wide references made in paragraph 42.6, the question arises where the boundaries of paragraph 10 lie exactly. In the opinion of the authors, further clarification is required. The authors suggest eliminating in paragraph 10 the distinctions made on the basis of personnel, now that paragraph 42.6 is the overarching provision.

32. Paragraph 42.3 makes the distinction between a contract with an Internet service provider and a place of business at the disposal of the enterprise. The authors opine that this could give rise to the avoidance of a permanent establishment by managing the contractual terms in cases where the circumstances would justify the permanent establishment conclusion instead. For that reason, they suggest the inclusion of a sentence to the effect that in this case, substance overrules form.

33. Article 5 (4) (f) deals with situations of "fragmentation", that is to say, situations where the establishment of the enterprise is such that any activities mentioned in article 5 (4) (a)-5 (4) (e) are so split up as not to be caught under article 5 (4) (f). In the context of anti-abuse, paragraph 27.1 was added in 2003 to clarify that places of business are not "separated organisationally" where they each perform in a Contracting State complementary functions. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is engaged in merely a preparatory or auxiliary activity. It is difficult to prove that fragmentation is being effected for tax purposes and for no other valid reason. Fragmentation is also referred to under article 5 (3), paragraph 20, third sentence. It can thus be said that fragmentation is deemed a danger for tax revenue and should be carefully considered.

34. There is, however, a form of fragmentation, which was addressed in the Philip Morris cases in Italy, that is approved in paragraph 41.1 of the 2005 update of the OECD Commentary. The express concentration on an individual enterprise only, without considering the presence of other group companies in the source State, could give rise to abuses, in cases where a group artificially splits up its activities over separate entities of that group, and where each company stays below the permanent establishment threshold of article 5.

35. For this reason, the authors believe that an addition to the Commentary to the effect that cases of obvious abuse shall be carefully evaluated, and that substance shall override form, is a must.

36. OECD is currently considering whether "in the name of" in article 5 (5) of the OECD Model Tax Convention could be interpreted also in an economic sense. Though this attempt at reinterpretation makes sense in the light of efforts to challenge abusive structures, the wording and history of the agency clause cannot bear such a reinterpretation.

37. Eventual suggestions of interpretations of this nature should be better avoided in the Commentary so that there is no negative impact in respect of deviating from court rulings. The decisions should be left completely to domestic courts, without an explicit position being taken by the United Nations in the Commentary.

IV. Conclusion

38. **In conclusion, the amendments being proposed are summarized as follows:**

(a) **The wording of article 5 of the text of the United Nations Model Tax Convention should not be amended;**

(b) **The OECD Commentary should be used as a basis upon which to formulate United Nations amendments;**

(c) **Drastic wording and far-reaching statements should be avoided;**

(d) **The addition of paragraph 4.5 to the OECD Commentary should be clarified further in that article 5 (3) of the text of the OECD Model Tax Convention is a special rule under the general rule of article 5 (1);**

(e) **Amendments and additions in paragraph 6 of the new OECD Commentary should not be added to the United Nations amendments;**

(f) **Paragraph 19 (eighth sentence) of the new OECD Commentary should have the words "all or parts of the projects" added to it;**

(g) **Paragraph 17 (third sentence) of the new OECD Commentary should read: "On-site planning and supervision of the erection of a building, construction, assembly or installation project are covered by paragraph 3";**

(h) **Paragraph 33 (fourth sentence) of the new OECD Commentary should read "authorised to negotiate all major elements and details of a contract in a way binding on the enterprise";**

(i) **The title of the chapter on electronic commerce found in the OECD Commentary should read "Electronic commerce and other activities with automatic equipment";**

(j) **The OECD amendments to paragraphs 42.1-42.10 on electronic commerce should be included in the United Nations amendments;**

(k) **The United Nations Commentary should reflect the position that substance overrides form when the OECD Commentary makes the distinction between Internet Service Provider services and the disposal of a server;**

(l) The relationship and the conflict between the content of paragraph 10 and that of paragraph 42.6 of the OECD Commentary should be clarified and resolved;

(m) Paragraph 41.1 of the OECD Commentary should clarify the fact that cases of obvious abuse shall be evaluated and that substance shall override form;

(n) The interpretation of the wording "in the name of" (article 5 (5) of both the OECD and the United Nations Model Tax Conventions) in an economic sense should not be attempted.

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